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FOR USAD0 MANILA

E.O. 11652:N/A

TAGS: EAID, EFIN

SUBJECT: INCREASE IN ADB LENDING RATE

1. SUMMARY. ON AUGUST 5, ADB BOARD OF DIRECTORS IS SCHEDULED TO VOTE ON ADB MANAGEMENT'S PROPOSALS TO RAISE ORDINARY CAPITAL LENDING RATE FROM 8.75 PERCENT TO 9.15 PERCENT TO RAISE COMMITMENT CHARGE FROM .34 PERCENT TO .45 PERCENT, TO CONSIDER CHANGING LENDING RATE IN OCTOBER ONLY IF IBRD LENDING RATE CHANGES BY MORE THAN 10 BASIS POINTS AND TO REDUCE PREMIUM CHARGE ON LOANS TO HONG KONG AND SINGAPORE FROM 75 TO 60 BASIS POINTS. BECAUSE OF THE IMPORTANCE ATTACHED BY THE U.S. GOVERNMENT TO ALL OF THESE ISSUES PLEASE CONTACT APPROPRIATE HOST GOVERNMENT OFFICIALS RESPONSIBLE FOR ADB AFFAIRS, RAISE POINTS DETAILED BELOW, AND SEEK TO HAVE INSTRUCTIONS SENT TO THEIR DIRECTORS IN MANILA ASAP. IN VIEW OF TIME ELEMENT, PLEASE CABLE HOST GOVERNMENT'S RESPONSE TO USADB MANILA AS WELL AS WASHINGTON END SUMMARY.

2. LENDING RATE. MANAGEMENT HAS PROPOSED THAT THE ORDINARY CAPITAL LENDING RATE BE RAISED FROM 8.75 PERCENT TO 9.15 PERCENT. THIS NEW RATE WILL PERMIT ADB TO MAINTAIN ITS TRADITIONAL 25 BASIS POINT SPREAD ABOVE INTEREST RATE OF WORLD BANK WHICH WAS RECENTLY RAISED TO 8.9 PERCENT. PROPOSED RATE WILL ALSO BE 15 BASIS POINTS ABOVE PROJECTED COSTS OF ADB BORROWINGS FROM INTERNATIONAL MARKETS. THIS IS FIRST TIME ADB IS PURPOSELY SETTING ITS LENDING RATE

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ABOVE THE COST OF ITS BORROWED FUNDS AND, AS SUCH, IS IMPORTANT STEP FOR ADB. WORLD BANK HAS JUST ADOPTED NEW SYSTEM, AT U.S. URGING, WHEREBY ITS LENDING RATE WILL BE ADJUSTED QUARTERLY TO REFLECT CHANGING BORROWING COSTS. A FIXED 50 BASIS POINTS ARE THEN ADDED TO COVER IBRD'S COSTS OF ADMINISTRATION AND LIQUIDITY. UNDER THIS SYSTEM IBRD RAISED ITS RATE FROM 8.5 PERCENT TO 8.85 PERCENT ON JUNE 1, FROM 8.85 PERCENT TO 8.9 PERCENT ON JULY 1. NEXT REVIEW WILL BE OCTOBER 1.

3. IT IS A MAJOR U.S. OBJECTIVE TO HAVE THE BANK ADOPT AN AUTOMATIC LENDING RATE FORMULA WHICH AUTOMATICALLY TIES BANK LENDING RATE TO THE BORROWING RATE WITH A SPREAD BETWEEN BORROWING COSTS AND LENDING RATES SUFFICIENT TO COVER ADMINISTRATIVE AND LIQUIDITY EXPENSES. SUCH A SYSTEM WOULD MAKE ORDINARY CAPITAL OPERATIONS OF THE INTERNATIONAL DEVELOPMENT BANKS FINANCIALLY SELF SUSTAINING AND LEAD TO EVENTUAL ELIMINATION OF NEED FOR PAID-IN FUNDS FROM MEMBER GOVERNMENTS. IMMEDIATE APPLICATION OF IBRD FORMULA, WITH THE APPROPRIATE SPREAD, TO ADB WOULD HAVE PRODUCED LENDING RATE OF 9.5 PERCENT. WE ARE, HOWEVER, PREPARED TO SUPPORT BANK MANAGEMENT'S 9.15 RATE, AS AN INTERIM STEP.

4. A NUMBER OF DIRECTORS AND ALTERNATES, INCLUDING THOSE FROM CANADA, FRANCE, INDONESIA, KOREA, PAKISTAN, PHILIPPINES AND THAILAND ARE SUPPORTING 9.10 PERCENT RATE. PLEASE BRING TO ATTENTION OF HOST GOVERNMENT OFFICIALS SERIOUS REPERCUSSIONS IF BOARD FAILS TO ACCEPT 9.15 PERCENT RATE. (A) REDUCTION IN 25 BASIS POINT SPREAD OVER IBRD RATE WOULD BE UNFORTUNATE PRECEDENT AND DIFFICULT TO REVERSE. AS ADB ORDINARY CAPITAL OPERATIONS ARE FAR FROM BEING FINANCIALLY SELF-SUFFICIENT THERE IS NO JUSTIFICATION FOR EVEN MARGINAL REDUCTION IN SPREAD. (B) A REDUCTION IN THE 25 BASIS POINT SPREAD WOULD RESULT IN HIGH BORROWING COSTS BECAUSE FINANCIAL COMMUNITY WOULD BECOME CONCERNED ABOUT BANK'S RESOLVE TO CONDUCT OPERATIONS ON A SOUND FINANCIAL BASIS. (C) AS HOST GOVERNMENTS ALREADY KNOW, USG IS NOT SUPPORTING ADB MANAGEMENT'S ORDINARY CAPITAL REPLENISHMENT PROPOSAL BECAUSE IT INCLUDES PROVISION FOR PAID-IN CAPITAL. U.S. RECONSIDERATION OF LIMITED OFFICIAL USE

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TION OF THIS POSITION WOULD BE MADE MORE DIFFICULT BY ANY INDICATION THAT ADB BOARD DOES NOT MAINTAIN ADDITIONAL 25 POINT SPREAD.

5. PREMIUM RATE. AS PART OF PRESENT PROPOSED OC RATE INCREASE TO 9.15 PERCENT, THE PREMIUM RATE PAID BY HONG KONG AND SINGAPORE WOULD DROP TO 60 BASIS POINTS FOR AN INTEREST RATE OF 9.75 PERCENT. HOWEVER, AUSTRALIAN DIRECTOR, REPRESENTING HONG KONG, IS PROPOSING TO HAVE PREMIUM RATE ELIMINATED COMPLETELY. USG WOULD RELUCTANTLY GO ALONG WITH MANAGEMENT'S PROPOSED REDUCTION IN PREMIUM TO 60 BASIS POINTS. (FYI. AS A LAST RESORT USG WOULD AGREE THAT RATE CHARGED TO HONG KONG AND SINGAPORE COULD REMAIN UNCHANGED AT 9.50 PERCENT. END FYI.)

6. COMMITMENT CHARGE. THE ADB IS PROPOSING TO RAISE THE

EFFECTIVE COMMITMENT CHARGE ON UNDISBURSED LOANS FROM .34 PERCENT TO .45 PERCENT. THIS COMPARES TO COMMITMENT FEES OF .75 PERCENT IN THE WORLD BANK AND IDB. ITS APPLICATION AT THE ADB WOULD HAVE A VERY BENEFICIAL EFFECT ON IMPROVING ADB'S FINANCIAL RATIOS, AND WHEN USED IN CONJUNCTION WITH OTHER FINANCIAL IMPROVEMENTS, IN REDUCING NEED FOR PAID-IN CAPITAL. THE USG BELIEVES THAT WHILE INCREASE IN THE COMMITMENT CHARGE IS A STEP IN THE RIGHT DIRECTION ADB IS STILL UNDERESTIMATING ITS TRUE COST OF LIQUIDITY. (FYI. SINCE THE HIGHER COMMITMENT

CHARGE WILL APPLY ONLY TO NEW LOANS FINANCED FROM MORE EXPENSIVE BORROWINGS IN THE FUTURE, THE COST OF LIQUIDITY SHOULD BE CALCULATED BY SUBTRACTING THE PROJECTED RATE OF RETURN ON SHORT TERM ADB INVESTMENTS (7.75 PERCENT) FROM THE PROJECTED BORROWING COSTS (9.0 PERCENT). THIS DIFFERENCE OF 1.25 PERCENT WHEN MULTIPLIED BY THE BANK'S LIQUID ASSET COEFFICIENT (.60) YIELDS .75 PERCENT. END FYI.)

7. PLEASE SEEK TO OBTAIN APPROVAL OF HOST GOVERNMENT FOR RAISING CHARGE TO .75 PERCENT.

8. RETROACTIVITY OF NEW LENDING RATE. NEW LENDING RATE LIMITED OFFICIAL USE

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(AT THAT TIME 9.10 PERCENT) WAS FIRST DISCUSSED AT ADB

BOARD ON JUNE 8, 1976. DIRECTORS OF KOREA, PHILIPPINES AND PAKISTAN LED SUCCESSFUL CAMPAIGN TO DELAY IMPLEMENTATION UNTIL AFTER THE WORLD BANK QUARTERLY DETERMINATION OF ITS LENDING RATE ON JULY 1. UNDER TERMS OF AGREEMENT, SETTING OF NEW RATE WOULD BE DELAYED UNTIL JULY, TO BE RETROACTIVE TO JUNE 8. THESE DIRECTORS HAD LOANS SCHEDULED FOR THEIR COUNTRIES IN JUNE AND ANTICIPATED THAT IBRD RATE WOULD DECLINE ON JULY 1. IF THIS HAD HAPPENED THESE DIRECTORS WOULD HAVE SAVED THEIR GOVERNMENTS FROM A TEMPORARILY HIGH ADB LENDING RATE. UNFORTUNATELY, IBRD RATE INCREASED AND THE DIRECTORS IN EFFECT GAVE UP A 9.10 PERCENT RATE FOR A 9.15 PERCENT RATE. IN AN EFFORT TO OBTAIN THE SUPPORT OF KOREA, PHILIPPINES AND PAKISTAN FOR SUPPORT OF 9.15 RATE USG WOULD SUPPORT ELIMINATION OF RETROACTIVITY ASPECT OF THE LENDING RATE INCREASE. HOWEVER, USG REQUIRES FIRM COMMITMENT FROM THESE GOVERNMENTS THAT THEY WILL SUPPORT BOTH THE 9.15 RATE AND THE MAINTENANCE OF A 60 BASIS POINT PREMIUM RATE FOR HONG KONG AND SINGAPORE IN EXCHANGE FOR DROPPING OF RETROACTIVITY.

9. 10 BASIS POINT RULE. WHILE PROPOSING THAT THE 9.15

PERCENT LENDING RATE BE EFFECTIVE UNTIL NEXT JANUARY, MANAGEMENT DOES RECOMMEND THAT THE ADB BOARD REVIEW THIS RATE IF THE IBRD LENDING RATE CHANGES BY MORE THAN 10 BASIS POINTS AS RESULT OF NEXT QUARTERLY ADJUSTMENT ON OCTOBER 1. USG WOULD PREFER THAT ADB AUTOMATICALLY ADJUST ITS RATE IF IBRD ADJUSTS ITS RATE BY 5 BASIS POINTS. UNDER ADB PROPOSAL THE ADJUSTMENT IS NOT AUTOMATIC. THUS, THE SPREAD BETWEEN ADB AND IBRD LENDING RATE COULD DROP TO LESS THAN 15 BASIS POINTS IF THE IBRD RATE RISES BY MORE THAN 10. INDICATE USG PREFERENCE FOR AN ADB ADJUSTMENT IF IBRD LENDING RATE CHANGES BY 5 BASIS POINTS INSTEAD OF MORE THAN 10 POINTS AS PROPOSED BY ADB MANAGEMENT.

10. PRIORITIES. (A) USG VIEWS AS THE MAJOR PRIORITY THE

INTRODUCTION OF A 9.15 PERCENT LENDING RATE, WHICH WOULD LIMITED OFFICIAL USE

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MAINTAIN THE HISTORICAL 25 BASIS POINT SPREAD OVER IBRD LENDING RATE. (B) THE SECOND PRIORITY IS OBTAINING THE AUTOMATIC ADJUSTMENT TO THE ADB LENDING RATE ON OCTOBER 1 BASED ON A 5 BASIS POINT MOVEMENT IN THE IBRD LENDING RATE. (C) THE THIRD PRIORITY FOR USG IS TO OBTAIN A .75 PERCENT COMMITMENT CHARGE. (D) THE FOURTH PRIORITY IS THE MAINTENANCE OF A PREMIUM CHANGE FOR THE HIGH INCOME COUNTRY BORROWERS, SINGAPORE AND HONG KONG. AS STATED IN PARA 5, USG WISHES TO HOLD TO MANAGEMENT'S PROPOSED 60 BASIS POINT PREMIUM, BUT AS A LAST RESORT WOULD SETTLE

TO HOLD RATE UNCHANGED AT 9.50 PERCENT. KISSINGER

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